Portfolio Perspectives

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Cryptos are Booming (and Busting, and Booming, and Busting)

Our team at Davidson Investment Advisors has long followed the progress, adoption, and potential use cases for cryptocurrency - both because of its potential to impact the businesses in which we invest, and because it is a rapidly-evolving and interesting corner of financial markets. While many of its most recent developments have largely elicited concern (crypto payments to computer hackers, rampant cryptocurrency speculation among day traders, etc.), we also find ourselves acknowledging its staying power and potential to disrupt currency and financial markets broadly. Compared to three or four years ago when an argument could be made that cryptocurrency was a fringe idea, perhaps now it can be best described as a speculative asset class in its own right; as such, we'd like to share some thoughts on cryptocurrency here.

In stark contrast to currencies as we have historically known them (regulated by central banks, traceable, and a reflection of the strength of its issuer), cryptocurrency represents a promise of pseudo-anonymity, liquidity, and unregulated use to its users. These characteristics make cryptocurrency attractive in many ways. For example, rather than living in a localized or regionalized economy dependent on the government(s) issuing currency to control inflation, money supply, and ease of access to capital (read: interest rates), cryptocurrency adopters can trade with a global market, unregulated and uncontrolled by anything except the broad market's perception of its value. As confidence in traditional institutions erodes (as it has for the last several years), an alternative like this may become more attractive. For instance, in Venezuela in 2018, due to hyperinflation and lack of trust, a running joke emerged among locals that chicken eggs had become the common currency of the people in the country. The idea of a currency that has limited supply, is in a trusted system and is outside the centralized influence of any government or central bank certainly has some merit - particularly in an environment where investors are increasingly concerned about monetary debasement from central banks and continued higher levels of fiscal debt. We note that cryptocurrencies also do not rot or otherwise go bad if left in the fridge too long (at least to our knowledge), as eggs did in Venezuela.

It should be mentioned, however, that cryptocurrencies have not thus far exhibited the stability that would make them a suitable store of value and means of transaction like a traditional currency. Rather, our team views these "currencies" as speculative investments at this point in their maturation. For example, Bitcoin's recent run and subsequent cratering of value from around $9,000/coin on June 18, 2020 to over $63,000/coin in April 2021 and back to approximately $35,000/coin as of June 18, 2021 illustrates the volatility of this asset class. Unless investors have confidence that the value of their currency is not going to rise dramatically in the future, they are not incented to exchange it for other goods and services today. Conversely, if investors expect the value of their currency to fall dramatically, they should spend (sell) it as quickly as possible in exchange for something with more lasting value. In this key respect, cryptocurrency cannot and will not serve as a replacement for traditional currency until investors coalesce around an accepted value for it.

So, how should we value cryptocurrency?

Bitcoin is the most widely adopted and well-capitalized cryptocurrency in the market today. While each cryptocurrency offers unique attributes and promises, we will focus on it for the purpose of this example. There is a fixed amount of Bitcoin available to investors: 21 million coins. As we look at it, if Bitcoin were to become the de facto currency globally by replacing the dollar, it would represent about $21 trillion in value - roughly the size of the United States economy. In this instance, we would assume a value of about $1 million per Bitcoin. If we assume the odds of Bitcoin becoming the future of money is 100%, we would pay roughly $1 million/Bitcoin; if we assume there is a 0% chance of this happening, we would assume Bitcoin is worthless and assign a value of $0. As Bitcon's value today is between these two figures, we interpret this to mean that Bitcoin has some applicability in replacing the role traditionally filled by dollars, and that investors are wagering that it could replace some portion of traditional currency over time.

As interesting as attempting to assign a value to Bitcoin is, our team finds more interest in exploring the potential applications of some of the unique features of cryptocurrencies.

Most notably, our team has spent time researching the underlying blockchain technology used in cryptocurrencies and the impact it could have across the economy (see: Davidson Investment Advisors' Trend reports from 2016 and 2018). In a blockchain, transactions are verified by network nodes through cryptography and recorded in a publicly distributed ledger. Distributed ledgers allow for transparent, verifiable, public records of transactions, assets, and contracts. Such technology has the potential to impact industries such as healthcare, financial services, and others through its highly-secure, auditable format. Any changes made to a blockchain are available to all, meaning that fraud, theft, or alteration of transaction records is extremely difficult.

Another interesting and potentially impactful application to arise from cryptocurrency is the idea of a "smart contract." The second-largest cryptocurrency, Ethereum, embeds additional software code in the form of a smart contract in transactions using this currency. The ability to add such contracts to the distributed public ledger provides an open, trusted network where the ability to verify asset ownership for both the buyer and seller and authenticate a purchase is quickly established. One use case for the technology is in real estate. Buying or selling a house involves multiple steps - verifying an individual's identity, confirming the availability of funds, transferring the title, etc.: a time-consuming and expensive process. Through the blockchain and embedded smart contracts, many or all these steps could be streamlined into code on a ledger, making the entire process significantly faster and less expensive by eliminating traditional middlemen such as title agents.

Non-Fungible Tokens (NFTs) are another use case where the Ethereum blockchain and smart contract is being used to verify and authenticate ownership of unique assets such as photos, videos, audio, and other types of digital files. While NFTs have thus far gained a reputation as being attached to speculative and somewhat confusing assets such as sports highlights, we believe their broader application extends to real assets such as cars, houses, and patents, which would enable asset owners to capitalize on their use and sale via this technology.

If this all sounds confusing, it's because it is. One commentator our team follows, Scott Galloway, has caught attention for saying, "I know more about cryptocurrency than 99% of people, and I know nothing about cryptocurrency." At this point, we believe the key takeaway for clients and investors is that there are some real attributes to the underlying technology behind cryptocurrency that are promising and will continue to see advancements. However, it is still very early in the evolution and adoption of this market and technology. Many like to compare Cryptocurrency and blockchain to the early days of the Internet. Similar to the early days of the Internet, markets became enamored with the potential opportunities, which led to enormous levels of speculation. Where the early days of the Internet would lead one to believe that Netscape, Pets.com, and AOL would be the long-term winners, we can observe today that companies such as Google, Amazon, and Facebook that did not even exist in the early days were the ones who emerged most dominant. We believe a similar dynamic may develop in the crypto ecosystem today; as the space develops, new coins, technologies, and real investment opportunities will emerge. At this point, we are positioned to observe and learn.

DISCLOSURES